Nos. 92-1384 and 92-1839

In The
Supreme Court of the United States
October Term, 1993

BARCLAYS BANK PLC,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

COLGATE-PALMOLIVE COMPANY,
Petitioner,
vs.
FRANCHISE TAX BOARD,
An Agency of the State of California,
Respondent.

On Writs of Certiorari to the Court of Appeal of the State of California in and for the Third Appellate District

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BRIEF OF CONGRESSMEN DON EDWARDS, HOWARD L. BERMAN AND XAVIER BECERRA AS AMICI CURIAE IN SUPPORT OF RESPONDENT FRANCHISE TAX BOARD

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QUESTIONS PRESENTED

Whether the Court should change the foreign policy of the United States with respect to State taxes after the Legislative and Executive Branches have refused to and, if so,

Whether the Commerce Clause requires a State to use a different accounting system to allocate profits for foreign corporations than it does for domestic corporations when Congress has refused for over thirty years to require such action?

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INTEREST OF AMICI

Amici appear before the Court as individual Members of Congress whose service on the Committee on the Judiciary of

the House of Representatives has given them a unique understanding of the issues presented by these cases that will be useful to the Court.[1]

The Judiciary Committee has general jurisdiction over the protection of trade and commerce against unlawful restraints and monopolies, Rule X. 1.(m)(16), Rules of the House of Representatives, and specific jurisdiction over bills regulating the authority of States to impose taxes on interstate commerce. 105 Cong. Rec. H. 11317 (June 18, 1959). As members of the Committee of the House of Representatives with specific subject matter jurisdiction, amici have a direct and continuing interest in the subject matter of these cases. Any legislation to reverse or modify this Court's decision in these cases would be brought to the Committee for its consideration and action.

SUMMARY OF ARGUMENT

Questions regarding State taxation of interstate and foreign commerce under the Constitution have always been directed in the first instance to Congress. The circumstances of these cases demonstrate the wisdom of this Court's policy of deferring to the judgment of Congress in these matters.

The States' refusal to use the "arm's-length" accounting method for allocating multinational companies' income has been the subject of extended Congressional consideration for over thirty years, but no legislation has been passed. Indeed, the United States Senate rejected a treaty proposed by the United Kingdom that would have prohibited States from using unitary accounting methods for multinational corporations.

[1] Amici submit this brief in support of Respondent with the consent of all parties. Written consents are on file with the Clerk of the Court.

The United Kingdom accepted that rejection after additional negotiations and concessions by the United States.

The political process has worked. Congress made an informed, conscious decision to allow the States to continue to use unitary accounting methods to allocate the income of multinational corporations. California exercised its discretion and decided to allow multinational corporations the choice of having the method applied to them effective January 1, 1988, Barclays Joint Appendix (BJA), Ex. 55, BJA-696, subsequently modified in 1993 by Senate Bill 671 (Cal. Stats. 1991, Ch. 881). See Respondent's Supplemental Brief in Opposition to Petition, Appendix A.

There is no constitutional justification for this Court to second guess the political process of the States and Congress and give Barclays special treatment just because it is a foreign corporation or give Colgate special treatment just because it conducts part of its business in foreign countries. The tax prerogatives of the States are determined by the elected officials in the States and the United States Congress after due deliberation; they should not be dictated by the wishes of corporate taxpayers or of foreign governments seeking to gain a competitive advantage for their own companies, which have the ability to shift massive amounts of profit abroad.

ARGUMENT

INTRODUCTION

The paramount question in these cases is whether a State is required by the Commerce Clause to use a different, and easier to evade, accounting standard to allocate profits for foreign corporations than it does for domestic corporations. Subsumed within this question is the more fundamental

question of how to strike a balance between State and national sovereignty under our federal system. The other issues raised by the parties involving the treaty power, foreign affairs, and supremacy are all derivative of the Commerce Clause question.

The requirements of the Commerce Clause and the subsidiary questions must be answered by reference to the Constitution, not by the demands of foreign nations seeking favored treatment for their corporations. The Constitution provides directions for the division of several specifically identified responsibilities and powers within a system of checks and balances.[2] In addition, as part of the Bill of Rights, the Tenth Amendment provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

This reservation of powers to the States is enforced through the structure of the federal government. "[T]he principal means chosen by the Framers to ensure the role of the States in the federal system lies in the structure of the Federal Government itself. It is no novelty to observe that the composition of the Federal Government was designed in large part to protect the States from overreaching by Congress." *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 550-551 (1985). Thus, the structure of Congress, consisting of two houses made up of representatives of the States, assures that the powers delegated to the federal

[2] The powers of the Legislative Branch, art. I, § 8, and Executive Branch, art. II, § 2, are described with some specificity. Limitations on the powers granted to the United States are enumerated, art. I, § 9, as are powers prohibited to the States, art. I, § 10.

government under the Constitution "will partake sufficiently of the spirit [of the States], to be disinclined to invade the rights of the individual States, or the prerogatives of their governments." *Id.* at 551 (internal quotations omitted). The Senate, in particular, with two members from each State and a restriction on the ability to change this characteristic by amendment is "at once a constitutional recognition of the portion of sovereignty remaining in the individual States, and an instrument for preserving that residuary sovereignty." *Id.* at 551-552 (internal quotations omitted).

In forming the federal government, the States agreed to cede a portion of their individual sovereign powers in order to enhance their collective power. Two of the principal motivating factors for the formation of the Union were: 1) the desire to conduct commerce, whether between themselves or with other nations, free of selfish impediments, and 2) the conduct of relations with foreign governments.

In furtherance of the first objective, Congress was given the power "[t]o regulate commerce, with foreign nations and among the several states. . . ." U.S. Const., art. I, § 8, cl. 3. To achieve the second of these objectives, the President was given "the power, . . . to make treaties. . ." art. II, § 2, cl. 2. The President's power, however was subject to the limitation that it could only be exercised "with the advice and consent of the Senate . . . provided two-thirds of the Senators present concur. . . ." *Id.* Thus, the structure of our federal government guarantees the States a voice in the establishment of both foreign and domestic policy through their representatives in Congress.

Maintaining this voice in the tax area is critical. Without the ability to raise revenue, a government loses the ability to provide the services for which it was formed. As a consequence, the States, in forming our Union, jealously guarded their revenue base. The Constitution directly limits State tax prerogatives only in the case of "imposts or duties on imports or exports," U.S. Const., art. I, § 10, cl. 2. There is no other specific prohibition on State taxation.

I. SINCE THE ISSUES IN THESE CASES HAVE BEEN INTENSIVELY CONSIDERED BY BOTH HOUSES OF THE CONGRESS, THIS COURT SHOULD ACCEPT THE JUDGMENT OF THE CONGRESS.

A. This Court Appropriately Defers To Congressional Consideration Of State Tax Issues Because They Involve Delicate Issues of Federalism.

In 1983, this Court decided that the taxes here at issue as applied to a domestic-based unitary business were constitutional under a Dormant Commerce Clause analysis. *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159 (1983). Since that time, the Congress has had numerous opportunities to change the result of that decision.[3] It has not done so. Indeed, recent efforts by the Administration to revise the federal "arm's-length" method to prevent multinational corporations from continuing to evade about $30 billion of federal taxes have not derailed public pressure to adopt a federal unitary method of taxing multinational corporations. *See*, Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes From Multinational Corporations*, Tax Notes, June 28, 1993, at 1841; John B. Judis, *Tax Brake, Clinton's Corporate Giveaway*, The New Republic, August 23, 1993, at 15.

[3] A list of some of the bills which have been introduced in Congress which would have affected the States' use of worldwide combined reporting is set forth in Stip. ¶ 38, BJA-40. None of these bills has been enacted. A list of the hearings which have been held by various Committees of Congress is set forth in the Joint Stipulation at ¶ 37, BJA-23-24.

Congress' repeated refusal to alter the result of *Container* should be respected by this Court. This Court should take the same position it took only eighteen months ago when it refused to overrule one of its prior decisions on a State tax, admittedly at odds with contemporary Commerce Clause jurisprudence. In part, this Court's reluctance was because Congress had the power to change the decision and was better equipped to balance the competing interests. *Quill Corporation v. North Dakota*, 504 U.S. ___, 119 L.Ed.2d 91 (1992).

If this Court takes its own counsel as set forth in *Quill*, it will respect the judgment of the Congress and sustain the taxes in dispute. California has amended its tax code to relieve the concerns of foreign governments. If any additional action is required, Congress has the power and a more appropriate institutional perspective than this Court to strike the necessary balance between the rights of the States and the concerns of foreign governments.

In order to preserve the delicate balance of our federal system, this Court has generally required "clear and manifest" affirmative action by Congress before it strikes down a non-discriminatory State law. *Puerto Rico Dept. of Consumer*

Affairs v. Isla Petroleum Corp., 485 U.S. 495, 500 (1988). For example, this Court sustained a State tax that differed from the federal tax, even when Congress thought State law would follow federal law, because Congress did not *require* States to follow federal law. *Amerada Hess Corp. v. New Jersey*, 490 U.S. 66, 70 (1989).

Indeed, this Court has upheld State taxes even when it apparently questioned the wisdom of the tax. For example, in 1981, this Court reviewed a severance tax imposed by the State of Montana on the mining of coal. The tax was imposed at the height of the energy crisis and was vociferously opposed by residents of less energy blessed states who used Montana's coal. This Court found the tax permissible under the Commerce Clause. "Under our federal system, the determination is to be made by state legislatures in the first instance and, if necessary, by Congress when particular state taxes are thought to be contrary to federal interests." *Commonwealth Edison Company v. Montana*, 453 U.S. 609, 628 (1981).

As Justice White stated in his concurrence:

> . . . Congress has the power to protect interstate commerce from intolerable or even undesirable burdens. . . . Yet, Congress is so far content to let the matter rest, and we are counseled by the Executive Branch through the Solicitor General not to overturn the Montana tax as inconsistent with either the Commerce Clause or federal statutory policy in the field of energy or otherwise. The constitutional authority and the machinery to thwart the efforts such as those of Montana, if thought unacceptable, are available to Congress, and surely Montana and other similarly situated States do not have the political power to impose their will on the rest of the country. . . . the better part of both wisdom and valor is to respect the judgment of the other branches of the Government. 453 U.S. at 637-638.

If anything, under the reasoning of this Court in *Commonwealth Edison*, even greater deference should be given to State income taxes because the interests of the taxpayers have almost certainly been considered by the elected officials. In *Mobil Oil Corporation v. Commissioner of Taxes*, 445 U.S. 425 (1980), this Court recognized the special character of income taxation:

> Concurrent federal and state taxation of income, of course, is a well-established norm. Absent some explicit directive from Congress, we cannot infer that treatment of foreign income at the federal level mandates identical treatment by the States. The absence of any explicit directive to that effect is attested by the fact that Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income. . . . Legislative proposals have provoked debate over issues closely related to the present controversy [apportionment and taxation of dividend income]. . . . Congress in the future may see fit to enact legislation requiring a uniform method for state taxation of foreign dividends. To date, however, it has not done so. (Citations omitted.) 445 U.S. at 448-449.

This Court found this to be true even when a different unitary formula was used by a State:

> While the freedom of the States to formulate independent policy in this area may have to yield to an overriding

national interest in uniformity, the content of any uniform rules to which they must subscribe should be determined only after due consideration is given to the interest of all affected States. It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions. *Moorman Manufacturing Company v. Bair*, 437 U.S. 267, 280 (1978).

This Court's judgment that issues involving State taxation and the Commerce Clause should be resolved under the Constitution by action of the Congress because it is better designed to balance the concerns of the States and the taxpayers is sound and should be respected. *See* Chapman, *Chadha, Garcia and the Dormant Commerce Clause Limitation on State Authority to Regulate*, 23 Urban Lawyer 163 (1991).

B. Over The Last Thirty Years Congress Has Consistently Refused To Pass Legislation Limiting The States' Power To Use The Unitary Method Of Allocating Income For Multinational Companies.

There is no question that the issues raised in these cases have been exhaustively reviewed by Congress. Every effort to prohibit the State taxes at issue has been rejected.

Shortly after the Court's decision in *Northwestern States Portland Cement Company v. Minnesota and Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S. 450 (1959),

Congress enacted Pub. L. No. 86-272 which, among other things, "initiated a comprehensive study of all matters pertaining to the taxation of income derived from interstate commerce. . ." *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1, p. 8.

The Judiciary Committee of the House of Representatives formed a special Subcommittee to study the issues presented by State taxation of corporate income. The Subcommittee conducted its study and hearings over several years. The results of this study are contained in five separate volumes and total over 2,600 pages of text and appendices. *State Income Taxation of Mercantile and Manufacturing Corporations: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary House of Representatives*, 86th and 87th Cong., (1961-1962) and *State Taxation of Interstate Commerce: Report of the Special Subcommittee on State Taxation of Interstate Commerce, Committee on the Judiciary, House of Representatives*, 88th and 89th Cong., 1st and 2d Sess. (1964-1965), Vol. 1-4. Two of the issues considered in these volumes are whether States should be able to use combined reporting unitary accounting and whether States should be able to consider income and activities outside of the United States in computing State taxes on multinational corporations. These are the issues presented by these cases. No legislation was enacted as a result of these hearings, study and report.

Additional hearings were held by the same Subcommittee in 1966 which resulted in an 1,800 page report. *Interstate*

Taxation Act, H.R. 11798 and Companion Bills: Hearings before the Special Subcommittee on State Taxation of Interstate Commerce of the Committee of the Judiciary, House of Representatives, 89th Cong., 2d Sess. (1966). Not one of the bills to limit unitary taxation of foreign corporations was enacted.

Similar hearings were held in 1973. *Hearings before the Subcommittee on State Taxation of Interstate Commerce of the Committee on Finance, United States Senate*, 93rd Cong., 1st Sess. (1973).

In 1977 and 1978, hearings were held with respect to federal regulation of state income taxation of interstate and foreign commerce. *Interstate Taxation, S. 2173: Hearings before the Senate Committee on the Judiciary*, 95th Cong., 1st and 2d Sess. (1977-1978). Stip. ¶ 37G, BJA-24.[4]

In 1980, the Senate Finance Committee held hearings on an Interstate Tax Bill, the primary purpose of which was to prohibit State use of worldwide combined reporting (WWCR) the unitary accounting method at issue in these cases. *State Taxation of Interstate Commerce and Worldwide Corporate Income, 1980: Hearings on S. 983 and S. 1688 Before the Subcomm. on Taxation and Debt Management Generally of the Senate Comm. on Finance*, 96th Cong., 2d Sess. (1980). Stip. ¶ 37E, BJA-24.

[4] The hearings in 1977-78 are of particular significance because they occurred at the time the United States Senate was considering whether it would give its advice and consent to the United States/United Kingdom Income Tax Convention with its restriction on State consideration of the activities of United Kingdom-based businesses to determine the income earned within the State. *See infra*, at pp. 14-19.

Also in 1980, the House of Representatives' Committee on Ways and Means held hearings on H.R. 5076,[5] the purpose of which was to prohibit the States' use of WWCR. No vote on the bill was even taken by the Committee.

In 1986, a Subcommittee of the Senate Finance Committee held hearings on S. 1113 and S. 1974, bills which were specifically introduced to limit the States' ability to use WWCR. These bills never even went to a Committee vote.

In *Commonwealth Edison Company v. Montana*, 453 U.S. 609 (1981), this Court pointed out that there had been Congressional consideration of the level of the Montana severance tax in both the 96th and 97th Congresses. 453 U.S. at 628, fn. 18. Contrast this with over thirty years of Congressional consideration of WWCR. If the consideration of six bills over two Congresses carries significance, then certainly importance should be attached to the consideration of over twenty bills during more than ten Congresses, Stip. ¶ 38, BJA-24-25, at least nine Congressional hearings, Stip. ¶ 37, BJA-23-24 and Second Stip. ¶ 37, BJA-47, and, as discussed below, the rejection of a treaty prohibition on the tax at issue.

Multinational corporations and foreign governments certainly know how to make their views known to Congress. *See*, Brooks Jackson, *Honest Graft*, Alfred A. Knopf, New York, 1988. Congress, however, has refused their entreaties, as should this Court.

[5] The report of those hearings is included in the record of this case. Stip. ¶ 37D, BJA-24.

C. **Since The Senate Refused To Give Its Consent To A Treaty Prohibiting The Taxes At Issue Here, This Court Should Accept The Senate's Judgment.**

In determining whether a State tax impinges on the federal government's ability to conduct foreign affairs, the affirmative action of the Senate in refusing to consent to a treaty with a prohibition on State unitary taxes should be dispositive. In establishing the treaty power, and in making it subject to the advice and consent of two-thirds of the Senate, the Framers had in mind the protection of the States against untoward encroachment on their sovereign powers by the federal government. Whether a State tax is a foreign policy concern of the United States is for Congress and the Executive to decide, not foreign governments.

In 1975, the United States and the United Kingdom concluded negotiations on revisions to the then-existing income tax treaty between the countries. One of the provisions included in the renegotiated treaty was a clause, Article 9(4), which would have limited the ability of the States to use WWCR on United Kingdom-based businesses such as Barclays. In submitting the treaty to the United States Senate for its advice and consent, the Executive Branch noted that this was the first treaty involving income taxation in which such a limitation on the States had been included. Letter of Submittal, June 8, 1976, 3 Tax Treaties Reporter (CCH) ¶10,938.

The proposed limitation on State (subnational) taxation contained in Article 9(4) was the subject of intense debate both within the Foreign Relations Committee and on the floor

of the United States Senate. Senator Frank Church attempted to attach a reservation to the treaty with respect to Article 9(4) both in Committee and on the Senate floor. One of his concerns was the use of the treaty process to circumvent Congressional consideration of an action which would affect commerce. See Ex. 36C, BJA-238, and 36D, BJA-311, generally, and especially BJA at 251-254. The efforts to attach a reservation failed.

However, when the treaty was presented to the Senate on June 28, 1978, for its advice and consent, the vote was 49 in favor and 32 against. The treaty failed to obtain the necessary consent of the United States Senate. 124 Cong. Rec. S. 18670 (June 23, 1978). The next day, the treaty, after the reservation of Article 9(4) was appended, passed the Senate by the constitutionally required two-thirds affirmative votes, 82 in favor and 5 against. 124 Cong. Rec. S. 19076 (June 27, 1978).

The treaty, as approved by the Senate, was returned to the Executive Branch, which transmitted it to the United Kingdom for its reconsideration. Because of the change in the treaty, the United Kingdom requested that negotiations be reopened. The United States agreed, and the additional negotiations gave rise to the Third Protocol to the Treaty which made additional concessions to the United Kingdom as the result of the Senate's reservation on Article 9(4).

The Third Protocol was considered by the United States Senate on July 9, 1979 and passed 98 in favor, to 0 against. 125 Cong. Rec. S. 17434 (July 9, 1979). Ex. 36B, BJA-193 at 227-229. The United Kingdom then approved the treaty as modified, and it became effective on March 24, 1980.

With a much weaker expression of intent by Congress, this Court ruled in *Wardair Canada v. Florida Department of Revenue*, 477 U.S. 1 (1986), that a State was not preempted from imposing a tax affecting foreign commerce. This Court in *Wardair* had before it: 1) a multilateral international convention which exhibited awareness of a similar state tax that was prohibited and silence with respect to the tax at issue, 2) a resolution of an international organization which would have prohibited the specific tax, and 3) bilateral agreements adopted after the resolution which committed the United States not to assert taxes at the national level similar to the State tax at issue but which were silent with respect to subnational taxes. This Court found that the second of these items, the Resolution, was of little relevance because it had not been endorsed or adopted by the federal government. The other two items, however, were found by this Court to establish that the State tax was expressly permitted. This Court said, "the Federal Government is entitled in its wisdom to act to permit the States varying degrees of regulatory authority. In our view, the facts presented by this case show that the Federal Government has affirmatively decided to permit the States to impose these . . . taxes. . . ." *Id.* at 12, and concluded that, "we never suggested . . . that the Foreign Commerce Clause *insists* that the Federal Government speak with any particular voice." (Emphasis in original.) *Id.* at 13.

The *Wardair* analysis compels the conclusion that the Senate's rejection of the proposed clause in the US/UK income tax treaty is an affirmative decision by the federal government to permit the State tax here at issue. There is no need to look to other bilateral agreements whose history is silent with respect to the relevant issue. There is no need to

look to the agreements of international organizations which suggest one thing and bilateral agreements which do something else *sub silentio*. All that is required is to look to the Senate's consideration and rejection of the proposed limitation on State tax prerogatives. This action does more than manifest permission by implication; it does it by action, action which was understood as permission both by the United States and the United Kingdom who were parties to the treaty, by the States and commercial enterprises who would have been affected by a prohibition, and by other countries as well.[6]

Congress is charged with the responsibility of regulating Commerce. The Senate, as one of the houses of Congress, bears this responsibility directly in considering legislation. It also performs this function when it is required to give its advice and consent to a treaty involving commercial relations with foreign countries. In considering the US/UK tax treaty, specifically Article 9(4), the Senate performed its role as guardian of State prerogatives.

> [T]he principal and basic limit on the federal commerce power is that inherent in all congressional action — the built-in restraints that our system provides through state participation in federal governmental action. The political process ensures that laws that unduly burden the States will not be promulgated. In the factual setting of these cases the internal safeguards of the political process have performed as intended. *Garcia*, 469 U.S. at 556.

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[6] See Ex. 42, BJA-477 and Ex. 43, BJA-480.

Barclays claims that the State tax here at issue fails what is commonly known as Dormant Foreign Commerce Clause analysis because it "prevent[s] this Nation from 'speaking with one voice' in regulating foreign commerce." *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434, 451 (1979). Alternatively, Barclays claims that California's tax is invalid because it impinges upon the ability of the federal government to conduct the foreign affairs of the United States. The same analysis applies to both arguments, *Japan Line*, 441 U.S. at 449 (1979); *Michelin Tire Corp. v. Wages*, 423 U.S. 276 (1976), particularly when the President negotiates a treaty affecting the commercial relations of the United States.[7]

Barclays' reliance on *Japan Line* is misplaced. *Japan Line* deals with a property tax, not an income tax. In that case, the federal government, by treaty, recognized that the international movement of cargo vessels should not be impeded by State taxes and, thus, there was a need to "speak with one voice." The taxation of multinational corporations' income raises entirely different concerns because they have the ability to shift income among a complex web of subsidiaries carefully designed to evade taxes. This Court has recognized that protecting the tax status of vessels and containers is vastly different than granting constitutional protection to the accounting artifices created by the tax departments of multinational corporations. Compare *Japan Line* with

[7] Because treaties often address commercial issues, the Constitution, art. II, § 2, cl. 2, provides that a treaty only becomes effective when two-thirds of the Senators present when it is considered give their advice and consent.

Container, which dealt with the same tax as is at issue in these cases and was decided four years later.

II. SINCE CONGRESS HAS DECIDED THAT THE STATES' USE OF THE UNITARY METHOD DOES NOT PREVENT THE GOVERNMENT FROM "SPEAKING WITH ONE VOICE," THIS COURT SHOULD NOT SUBSTITUTE ITS JUDGMENT FOR THAT OF CONGRESS

In *Container*, this Court recognized that the overlapping Commerce Clause and foreign affairs Constitutional questions are peculiarly political in nature. In making the "one voice" element part of its Commerce Clause analysis in *Container*, this Court recognized its institutional limitation in considering these issues:

> . . . In considering this issue, however, we are faced with a distinct problem. This Court has little competence in determining precisely when foreign nations will be offended by particular acts, and even less competence in deciding how to balance a particular risk of retaliation against the sovereign right of the United States as a whole to let the States tax as they please. 463 U.S. at 194.

This Court stressed that the "one voice" element was peculiarly an issue for the Executive and Legislative Branches:

> . . . the foreign policy of the United States — whose nuances, we must emphasize again, are much more the province of the Executive Branch and Congress than of this court. 463 U.S. at 196.

The "one voice" analysis involves determining whether a state tax will "impair federal uniformity in an area where federal uniformity is *essential.*" (Emphasis added.) *Japan Line*, 441 U.S. at 448. In *Container*, this Court said that uniformity might be essential if the State tax "might *justifiably* lead to significant foreign retaliation." (Emphasis added.) 463 U.S. at 194. The facts of this case demonstrate that suppressing a State's right to choose its tax system is not essential to uniformity and the retaliation threatened by the United Kingdom was resolved by the political system.

In any event, once United States foreign policy has been made, suggesting that the Constitution requires it be changed in the face of foreign threats is a dangerous precedent. It would encourage threats and retaliatory legislation where none would have been considered.

A. Congress Has Decided That Identical Taxation Of Multinational Corporations By The States And Federal Government Is Not Essential For Our Country To Speak With "One Voice" In Foreign Policy.

This Court recognized in *Container* that the determination of whether uniformity in this area is *essential* is a decision which must be made in the first instance by the Executive and Legislative Branches, 463 U.S. at 194. Congress' refusal to pass any one of innumerable bills to prohibit the States' use of WWCR for almost thirty years evidences a conviction that uniformity in this area is not essential. If it were, Congress would have acted.

Circumstances have proved Congress to be correct. Foreign commerce continues. Residents of the United

Kingdom, the nation that has gone the furthest in threatening retaliation, continue to be among the single biggest investors in the United States[8] and in California.[9]

B. Threats Of Retaliation By Foreign Governments Should Be Handled By The Political System, Not This Court.

The United States' Income Tax Conventions, except with respect to non-discrimination, do not apply to taxes asserted by subnational jurisdictions such as States. *E.g.*, The United States Model Income Tax Treaty. Ex. 45, BJA-560. In presentations to international groups, representatives of the Treasury have stated that the United States will not include subnational taxes under treaties, with the exception of nondiscrimination, because the Senate will not approve it. See Ex. 37H, BJA-436 at 438.[10] Because these foreign governments have been unable to get the Executive and Congress to change the policy of the United States government, they are now asking this Court to change the policy of the United States as a matter of constitutional law.

Despite the additional benefits the United Kingdom got because it accepted the US/UK tax treaty without a prohibition on State taxation, it reneged on the deal and threatened to

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[8] *Foreign Direct Investment in the United States: An Update*, U.S. Dept. of Commerce (June 1993), p. 23.

[9] *Foreign Direct Investment in California*, State of California (Nov. 1993), pp. 4-5.

[10] Material is from a submission by the Department of Treasury to XIX Inter-American Center on Tax Administrators (CIAT) Technical Conference on "Exchange of Information Under Tax Treaties" August 28-September 3, 1977, Curacao. Ex. 37H. *International Tax Treaties: Hearing before the Senate Comm. on Foreign Relations*, 96th Cong., 1st Sess. (June 6, 1979), p. 111-112 (statement of Donald C. Lubick).

withdraw a benefit which the same treaty conferred upon United States corporations, Ex. 40GG, BJA-444 at 455-459, Article 10, because of the States' continued use of WWCR. The United Kingdom has now withdrawn the threat of retaliation, but holds it in reserve if it is displeased with California's implementation of its new "water's-edge" legislation or if another State should choose to adopt WWCR. *See* State Tax Notes, 93 STN 181-16 (September 20, 1993). This Court should not encourage the United Kingdom to hold hostage either United States foreign policy or United States internal policy regarding the powers of the States.

Perhaps one reason the United Kingdom threatened to breach the treaty is because unitary accounting undercuts the *raison d'etre* of British tax havens such as the Channel Islands, the British Virgin Islands, Gibraltar, Hong Kong and the Cayman Islands, which are used by offshore corporations to evade taxes under the "arm's-length" method of accounting. In fact, the Crown Colony of the Cayman Islands is now the fifth largest banking center in the world.

C. The Practical Effect Of Limiting Use Of The Unitary Method Will Be To Impair The Ability Of American Companies To Compete Against Foreign Companies.

Although the legal issue in the *Barclays* case is whether it is constitutional for a State to impose the same tax accounting requirements faced by domestic companies upon foreign multinational corporations, the real issue is whether foreign multinational corporations will be allowed to shift their tax burden onto domestic corporations as a matter of constitutional law. If Barclays prevails, domestic companies will be forced

to pay the taxes that the foreign companies will escape. Indeed, if Barclays prevails, our domestic companies will have to compete against foreign corporations which pay no income taxes whatsoever on their exports to the United States because in many countries there is no corporate income tax, only a Value Added Tax on products which is rebated to a corporation if it exports the product.

The "arm's-length" method used by the federal government essentially allows a corporation to use intra-company sales as a method of allocating income. For example, if a Japanese auto manufacturer sold a car to its U.S. distributor for $30,000, its U.S. distributor might sell it for $32,000. After deducting administrative and advertising costs for its U.S. subsidiary, the Japanese company could declare that it lost money on the sale in the U.S. even if it booked a $10,000 profit on that car in Japan when it sold it to its U.S. distributor.

Unfortunately, trying to police the "arm's-length" system is like trying to police the New Jersey turnpike on a bicycle. According to every former Commissioner of the Internal Revenue Service who testified before the Oversight Subcommittee of the House Ways and Means Committee, the IRS is totally outgunned by these corporations when it somehow discovers an egregious example of revenue shifting and tries, using the "arm's-length" method, to collect the taxes that should have been paid.[11] In an attempt to stop some of

[11] *Tax Underpayment by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives*, 101st Cong., 2d Session, July 10 and 12, 1990, at 41.

(continued...)

the abuse, the IRS recently issued complex temporary regulations,[12] but so far all they appear to have generated are seminars in vacation spots for lawyers, accountants and economists eager to learn how to work the system for their clients and a spate of articles moaning about the onerous burdens being imposed by these new regulations.[13]

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[11](...continued)

In 1992, the Subcommittee revisited the 36 firms it studied in 1990 and found that these firms actually paid less taxes than reported originally. *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives*, 102d Cong., 2d Sess., April 9, 1992, at 5.

[12] 26 CFR §§ 1.481.1 through 1.483-2T, 58 Fed. Reg. 5263 (June 21, 1993).

[13] Witnesses Say Transfer Pricing Penalty Regs are Too Restrictive, Tax Notes, May 24, 1993, p. 1005; Panels Ponder Foreign Tax Issues, Tax Notes, May 17, 1993, p. 877; William L. Raby, CPA, Section 482 and the Under $10-Million Corporation, Tax Notes, March 22, 1993, p. 1637; James P. Fuller and Ernest F. Aud, Jr., The New Temporary and Proposed Section 482 Regulations: A Wolf in Sheep's Clothing?, Tax Notes, March 15, 1993, p. 1517; Transfer Pricing Regs Don't Require Proving a Negative, Official Says, Tax Notes, March 15, 1993, p. 1413; Burgess J. Raby and William L. Raby, Section 482 Reasonable Cause Proposal Not Reasonable, Tax Notes, March 8, 1993, p. 1347; Kellogg Management School Conducts Conference on Transfer Price Regs, Tax Notes, February 22, 1993, p. 1015; John Simpson et al., From "CPI or Die" to the Best Method Rule: An Economic Analysis of the Arm's Length Standard Under the New IRS Regulations for Intercompany Pricing, Tax Notes, February 22, 1993, p. 1089; Steven P. Hannes, Esq., An Evaluation of IRS's 1993 Transfer Pricing and Related Penalty Proposals: Round Three, Tax Notes, February 15, 1993, p. 933; Treasury's Mogle Offers Insights on New Transfer Pricing Regs, Tax Notes, February 8, 1993, p. 683; George N. Carlson, et al., Deja Vu All Over Again: The New Section 482 Regulations, Tax Notes, February 1, 1993, p. 607; IRS Releases Temporary Transfer Pricing Regs, Tax Notes, January 18, 1993, p. 287.

Under these circumstances, it is hopelessly naive to believe that profit-maximizing corporations, making any kind of a cost-benefit calculation, will not structure their accounting to minimize taxes. Given a vague standard and ineffectual enforcement, it would be inconceivable not to expect managers to do all they can to shift revenue to the lowest tax jurisdiction. The rewards weighed against the risks are simply too great. No public policy should be based on a notion that corporate managers are more virtuous or public spirited than the general run of mankind.

A June 1993 Commerce Department Report to Congress on Foreign Direct Investment in the United States estimated that one half of the taxes owed by foreign multinational corporations were evaded by transfer pricing abuses. By one estimate that is about $30 billion a year[14] — real money even in federal government terms. According to the IRS, in 1989, the last year for which data is available, 71.7% of foreign companies paid no U.S. taxes at all and, as a group, reported less than one third the taxable income of U.S. firms as a percentage of receipts (.9% v. 3.1%) despite the fact that their

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[14] A study by Professor James A. Wheeler summarized in Lobel, Banta & Gueron, *Barclays: A Test of the Administration's Willingness to Collect Taxes from Multinational Corporations*, Tax Notes, June 28, 1993, at 1842. *See also* a study by Professors Pak and Zdanowicz reported in Tax Analysts Highlights & Documents, January 11, 1994, at 11, which estimated that "Foreign-held firms used transfer pricing shenanigans to dodge an estimated $28 billion or more in federal income taxes in 1992. . . ." They "found that trade with Japan accounted for an estimated 13 percent of lost U.S. income tax revenues, or more than $4 billion annually. Other countries with "abnormalities" exceeding $1 billion were: Germany ($3.1 billion); Britain ($2.5 billion); Canada ($2.1 billion); France ($1.6 billion); Mexico and Taiwan ($1.4 billion); the Netherlands ($1.3 billion); and Brazil ($1.1 billion)."

assets went up three times as fast as domestic companies. Apparently, they are losing money on every sale, but making it up in volume!

Because these foreign corporations failed to get Congress to prohibit State use of unitary tax systems that this Court has consistently recognized as at least as accurate a method as the "arm's-length" method of allocating income, *Allied-Signal v. Dir. Div. of Taxation*, 504 U.S. ___, 119 L.Ed.2d. 533 (1992), they are now asking this Court to prohibit State use of unitary tax systems against foreign multinational corporations on constitutional grounds. They argue that unitary tax systems are too burdensome to apply and violate international standards. The first point doesn't even pass the smile test: How can the management of a corporation suggest with a straight face that it does not know where its sales, personnel and property (the usual factors in unitary accounting systems) are located? On the second point, the one time such a prohibition was included in a treaty, the Senate refused to pass the treaty until the prohibition was removed.

The only consistent theme in the multinationals' argument against the unitary method of allocating income or against making the "arm's-length" method more effective is that they don't want to pay taxes. Nor do most taxpayers, but most recognize that payment of taxes (even when there is disagreement with their expenditure) is the price of a civilized society.

CONCLUSION

Since (1) Congress has refused for over thirty years to pass legislation prohibiting States from using the unitary method for allocating the income of multinational corporations

and, in fact, the one time it was faced directly with the issue, refused to consent to a treaty which contained such a prohibition, and (2) this Court has consistently recognized that the unitary method is as well accepted and at least as accurate a method as the "arm's-length" method of allocating income, this Court has no basis to find that the States' use of the unitary method violates the Constitution.

The decisions of the California Courts in these cases should be affirmed.

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Respectfully submitted,

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